

Beyond Aid:

New Sources and Innovative Mechanisms for Financing Development in Sub-Saharan Africa

Dilip Ratha
Sanket Mohapatra
Sonia Plaza

The World Bank
Development Prospects Group
Migration and Remittances Team
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Abstract

Given Sub-Saharan Africa's enormous resource needs for growth, poverty reduction, and other Millennium Development Goals, the development community has little choice but to continue to explore new sources of financing, innovative private-to-private sector solutions, and public-private partnerships to mobilize additional international financing. The paper suggests several new instruments for improving access to capital. An analysis of country creditworthiness suggests that many countries in the region may be more creditworthy than previously believed. Establishing sovereign rating benchmarks and credit enhancement through guarantee instruments provided by multilateral aid agencies would facilitate

market access. Creative financial structuring, such as the International Financing Facility for Immunization, would help front-load aid commitments, although these may not result in additional financing in the long run. Preliminary estimates suggest that Sub-Saharan African countries can potentially raise \$1-3 billion by reducing the cost of international migrant remittances, \$5-10 billion by issuing diaspora bonds, and \$17 billion by securitizing future remittances and other future receivables. African countries that have recently received debt relief however need to be cautious when resorting to market-based borrowing.

This paper—a product of the Migration and Remittances Team of the Development Prospects Group—is part of a larger effort in the department to analyze innovative instruments that developing countries can utilize for mobilizing development financing. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The author may be contacted at dratha@worldbank.org.

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Dilip Ratha, Sanket Mohapatra, and Sonia Plaza

Development Prospects Group

The World Bank

Washington DC 20433

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1. Introduction

Official aid alone will not be adequate for funding efforts to accelerate economic growth and poverty alleviation and other Millennium Development Goals (MDGs) in Africa. Ultimately the private sector will need to be the engine of growth and employment generation, and official aid efforts must catalyze innovative financing solutions for the private sector. It is important to stress that financing MDGs would require increasing the investment rate above the domestic saving rate, and bridging the financing gap with additional financing from abroad.¹

This paper examines the level and composition of resource flows to Sub-Saharan Africa: foreign direct investment (FDI), portfolio debt and equity flows, bank lending, official aid flows, capital flight, and personal and institutional remittances. Recognizing that South Africa is expectedly the largest economy and the most dominant destination of private flows, the analysis focuses on the rest of Sub-Saharan Africa wherever appropriate.² The paper then examines some new or overlooked sources of financing such as diaspora bonds and remittances, and some innovative mechanisms such as future-flow securitization and partial guarantees provided by multilateral agencies, for raising additional, cross-border financing in the private sector. In passing, the paper also briefly discusses recent initiatives, such as the Global Alliance for Vaccines and Immunization (GAVI) and the International Financing Facility for Immunization (IFFIm), that use innovative methods to front-load future financing commitments from bilateral donors in order to introduce more predictability in aid flows.³

Resource flows to Sub-Saharan Africa have increased since 2000, a welcome reversal of the declining or flat trend seen during the 1990s. Official Development Assistance (ODA) to the region excluding South Africa has increased from \$11.7 billion in 2000 to \$37.5 billion in 2006;

¹ Local borrowing by one investor would lower the availability of capital for another borrower, a point often overlooked in the literature.

² From 2000 to 2005, almost all portfolio flows went to South Africa. In contrast, the rest of Sub-Saharan Africa received the bulk of official development assistance and remittances.

³ Some of the other initiatives under consideration, although in a more preliminary form, include an international airline tax and a levy on international currency transactions (see discussions of Second and Third Plenary Meetings of the Leading Group on Solidarity Levies to Fund Development [<http://www.innovativefinance-oslo.no> and <http://www.innovativefinance.go.kr>]). See also Kaul and Le Goulven (2003), Technical Group on Innovative Financing Mechanisms (2004), and United Nations (2006).

FDI increased from \$5.8 billion to an estimated \$17.2 billion in 2006;⁴ while net private bond and bank lending flows decreased from \$-0.7 billion to an estimated \$-2.5 billion during the same period.⁵ Capital outflows from the region have also started reversing in recent years. Workers remittances to Sub-Saharan Africa more than doubled from \$4.6 billion in 2000 to \$10.3 billion in 2006; and institutional remittances increased from \$2.9 billion in 2000 to \$6.3 billion in 2006. New donors and investors (for example, China and India) have increased their presence in the region.

The picture is less rosy, however, when Sub-Saharan Africa is compared with the other developing regions. Sub-Saharan Africa continues to depend on official aid for its external financing needs. In 2006, ODA was more than two-and-a-half times the size of private flows received by Sub-Saharan Africa excluding South Africa. The recent increase in ODA appears to be driven by debt relief provided through the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative (IBRD 2007).⁶ According to IBRD (2007), debt relief represented close to 70 percent of the increase in bilateral official development assistance (ODA) to Sub-Saharan Africa between 2001 and 2005. The relatively small FDI flows to the region went mostly to enclave investments in oil-exporting countries.⁷ Portfolio bond and equity flows were almost non-existent outside South Africa. Private debt flows were small and predominantly relationship-based commercial bank lending,⁸ and even these flows were mostly short-term in tenor. Less than half the countries in the region have a sovereign rating from the major credit rating agencies. Of those that are rated, most have below-investment grade ratings. Capital outflows appear to be smaller than in the previous decade, but the stock of flight capital from the region remains high. Migrant remittances appear to be increasing, but much of the flows are believed to be unrecorded as they bypass formal financial channels. In short, there is little room for complacency; efforts to explore new sources and innovative mechanisms for financing development in the region must continue.

The paper suggests several new instruments for improving access to capital of Sub-Saharan African countries. The analysis of country creditworthiness suggests that many countries

⁴ Although the amount received by Sub-Saharan Africa is tiny compared with the total FDI flows to developing countries, as a share of GDP it is equivalent to 2.4 percent, comparable to the share of FDI in the GDP of other developing regions.

⁵ There is a reporting lag in the transfer items of the balance of payments statistics. Data on official debt flows were unavailable for 2006 as of March 2008.

⁶ Aid effectiveness is hampered by coordination difficulties among donors and by a lack of absorptive capacity among borrowers in the region (see Gelb, Ramachandran, and Turner 2006; IBRD 2006; World Bank 2006).

⁷ Oil exporters in Sub-Saharan Africa comprise nine low- and middle-income countries (Angola, Cameroon, Chad, the Democratic Republic of Congo, the Republic of Congo, Equatorial Guinea, Gabon, Nigeria, and Sudan) with a combined gross domestic product of \$255 billion or 37 percent of Sub-Saharan Africa's gross domestic product in 2006.

⁸ Only one middle-income oil-exporting Sub-Saharan African country, Angola, accounted for virtually all of net bank lending to Sub-Saharan African countries other than South Africa from 2003 to 2005. More recent data on syndicated loans suggests that bank lending has grown since, but mainly in resource rich countries such as Angola, Liberia, Nigeria and Zambia.

in the region appear to be more creditworthy than previously believed. Establishing sovereign rating benchmarks and credit enhancement through guarantee instruments provided by multilateral aid agencies would facilitate market access. Creative financial structuring, such as the IFFIm, can help front-load aid commitments, although they may not result in additional financing in the long run. Preliminary estimates suggest that Sub-Saharan African countries can potentially raise \$1 billion to 3 billion by reducing the cost of international migrant remittances, \$5 billion to 10 billion by issuing diaspora bonds, and \$17 billion by securitizing future remittances and other future receivables.

African countries, however, need to be cautious when resorting to market-based debt. It is essential that the borrowing space created by debt relief is used prudently, and not used to borrow excessively at commercial terms (IBRD 2007). “Free riding” by commercial and bilateral creditors can even lead to another round of excessive accumulation of debt.⁹ Countries should also monitor and manage short-term external debt (especially those intermediated by domestic banks) to avoid currency and maturity mismatch between assets and liabilities and potential liquidity crisis (Dadush, Dasgupta and Ratha 2000). Short-term capital flows can reverse rapidly with potentially destabilizing effects on the financial markets.

The paper is structured as follows. The following section analyzes trends in resource flows to Sub-Saharan Africa relative to other developing regions. The next section highlights some new sources and innovative mechanisms for development financing in the region. And the final section concludes with a summary of findings and some recommendations for the way forward.

2. Trends in Financial Flows to Sub-Saharan Africa

Resource flows to Sub-Saharan Africa have risen in recent years, but the region’s external finances are less diversified than in the other developing regions

In one of the largest expansions in private capital flows to developing countries in recent decades, private medium and long-term capital flows nearly tripled in size from \$195 billion in 2000 to \$670 billion in 2006. This period also saw significant diversification in the composition of private flows to developing countries (for FDI, portfolio bond and equity flows, bank lending, and derivative instruments). Official development assistance nearly doubled from \$54 billion to \$104 billion, as did migrant remittances, from \$85 billion in 2000 to \$221 billion in 2006.

Official aid flows to Sub-Saharan Africa also rose, from \$12.2 billion in 2000 to \$38.2 billion (or 37 percent of ODA to developing countries) in 2006. Private resource flows to Sub-Saharan Africa (other than FDI), however, have risen at a slower pace compared to other

⁹ “Free riding” implies that new lenders might extend credit to risky borrowers taking advantage of the improvement in the latter’s credit risk following debt relief and concessional loans by official creditors (IBRD 2007).

developing regions, and the region's share of private capital flows to developing regions has continued to remain small and undiversified (table 1).

Table 1: Financial flows to Sub-Saharan Africa and other developing countries, 2006

<i>(US\$ billions)</i>	1990	1995	2000	2005	2006 estimate	Growth rate, 2000-06 (%)
<i>Sub-Saharan Africa excluding South Africa</i>						
Official flows						
ODA ^{1/}	17.0	17.4	11.7	30.1	37.5	220%
Official debt	4.3	3.5	0.7	-0.7	-2.5	..
Private medium and long-term flows	0.8	3.9	5.1	12.4	14.8	189%
FDI	1.3	3.3	5.8	10.8	17.2	197%
Portfolio equity	0.0	0.1	0.0	0.2	0.1	..
Bond	0.0	0.2	-0.2	0.0	-1.4	..
Bank lending	-0.5	0.3	-0.5	1.4	-1.1	..
Private short-term debt	2.3	1.1	-1.4	1.0	4.6	..
Migrants' remittances ^{2/}	1.7	3.1	4.3	8.7	9.6	124%
Institutional remittances	1.4	2.3	2.9	5.4	6.2	117%
Capital Outflows	3.2	5.3	6.3	7.5	3.6	..
<i>South Africa</i>						
Official flows						
ODA ^{1/}	0.0	0.4	0.5	0.7	0.7	47%
Official debt	0.0	0.0	0.1	0.1	0.0	..
Private medium and long-term flows	0.3	4.0	6.2	17.4	16.1	160%
FDI	-0.1	1.2	1.0	6.5	-0.1	..
Portfolio equity	0.4	2.9	4.2	7.2	15.0	257%
Bond	0.0	0.7	1.2	1.3	1.6	32%
Bank lending	0.0	-0.8	-0.2	2.4	-0.4	..
Private short-term debt	0.0	1.9	0.3	1.8	5.6	1940%
Migrants' remittances ^{2/}	0.1	0.1	0.3	0.7	0.7	114%
Institutional remittances	0.1	0.0	0.0	0.1	0.1	..
Capital Outflows	0.2	4.1	3.3	2.5	10.5	214%
<i>Other developing regions</i>						
Official flows						
ODA ^{1/}	37.3	41.0	41.5	76.1	65.7	58%
Official debt	19.8	35.4	-6.6	-69.9	-13.8	..
Private medium and long-term flows	30.9	158.9	183.3	465.5	639.2	249%
Private short-term debt	11.5	54.1	-5.3	86.8	84.1	..
Migrants' remittances ^{2/}	29.2	54.3	79.9	181.9	211.0	164%
Institutional remittances	15.7	14.0	26.9	58.1	63.0	134%
Capital outflows	34.6	79.9	163.3	364.7	545.4	234%

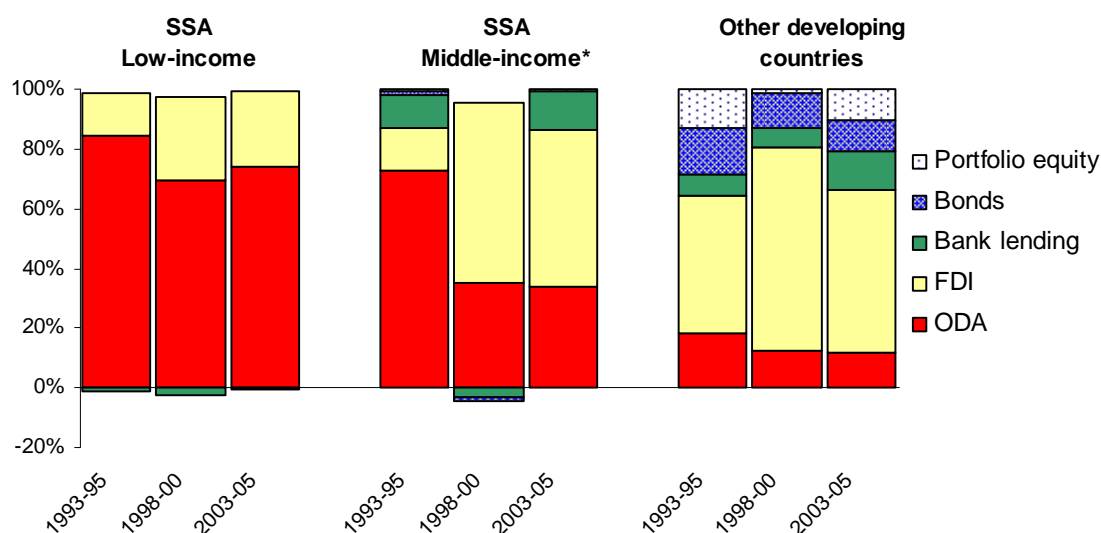
1/ / Development Assistance Committee donors only. 2/ Migrants' remittances are the sum of workers' remittances, compensation of employees, and migrants' transfers (World Bank 2005).

Source: Authors' calculations; *Global Development Finance* database, March 2008.

FDI to Sub-Saharan African countries other than South Africa rose from \$5.8 billion in 2000 to an estimated \$17.2 billion in 2006, making FDI the second-largest source of external finance. However, a large part of FDI in the region is concentrated in enclave investments in a few resource-rich countries. Portfolio equity flows to Sub-Saharan Africa increased from \$4.2 billion in 2000 to an estimated \$15.1 billion in 2006, but almost all of these flows (\$ 15 billion) went to South Africa. Debt flows were mostly short-term bank credit secured by trade receivables—medium- and long-term bank lending was concentrated in Angola and South Africa, and international bond issuance was concentrated in South Africa until 2006.

Sub-Saharan Africa excluding South Africa received a minuscule 2.2 percent of medium and long-term flows received by developing countries. Medium and long-term private capital flows to Sub-Saharan Africa excluding South Africa increased from \$5.1 billion in 2000 to an estimated \$14.8 billion during 2006. Private flows to South Africa alone were significantly larger throughout this period (table 1). The low- and middle-income Sub-Saharan African countries barring South Africa and a few commodity exporters have benefited little from the surge in private debt and portfolio equity flows to developing countries (figure 1).

Figure 1: Resource flows to Sub-Saharan Africa remain less diversified than to other developing regions



* Excludes South Africa.

Source: Authors' calculations; World Bank 2007a.

Official aid continues to be the dominant source of external finance for Sub-Saharan Africa

Sub-Saharan African countries rely heavily on official aid flows compared to other regions. At \$38.2 billion, ODA is the largest source of external financing for Sub-Saharan

African countries, both in dollar amounts and as a share of gross domestic product (GDP). In 2006, ODA to Sub-Saharan countries other than South Africa was \$37.5 billion or 8.2 percent of GDP, compared with 1 percent for all developing countries. Medium- and long-term private capital flows were only a fraction (about 40 percent) of official flows in Sub-Saharan African countries other than South Africa, while they were almost 10 times the size of official aid flows in other developing regions (figure 1).

Aid flows to Sub-Saharan Africa declined until the late 1990s, but have increased again in recent years. Official aid to Sub-Saharan African countries other than South Africa declined between 1995 and 2000, from \$17.4 billion to \$11.7 billion. ODA has increased again in recent years with a substantial scaling up of aid. However, debt relief under the HIPC Initiative and the MDRI and exceptional debt relief provided by Paris Club creditors to Nigeria in 2005-06 have contributed a large share of this increase in official flows (IBRD 2007; World Bank 2007a). According to IBRD (2007), debt relief represented close to 70 percent of the increase in bilateral official development assistance (ODA) to Sub-Saharan Africa between 2001 and 2005.¹⁰ Net official debt flows have declined dramatically in recent years (from 1.5 percent of GDP in the early 1990s to 0.3 percent of GDP in 2000-05 for Sub-Saharan African countries for which data were available in 2005) as debt relief under the HIPC Initiative and MDRI has reduced debt stocks and the stream of future repayments for many Sub-Saharan African countries.¹¹

Although developed countries have pledged to substantially increase aid flows to Sub-Saharan Africa substantially over the next decade, recent pledges for scaling up aid have not yet materialized for many donor countries. Excluding the exceptional debt relief to Nigeria, real ODA flows to Sub-Saharan Africa fell in 2005 and stagnated in 2006 (IBRD 2007).¹² The promised doubling of aid to Africa by 2010 seems unlikely at the current rates of growth. The lack of predictability of future aid is a cause for concern in addition to the duplication of activities among donors and misalignment of the donor community priorities' with the country's development objectives.

¹⁰ Paris Club creditors provided \$19.2 billion exceptional debt relief to Iraq and Nigeria in 2005 and a further \$14 billion in 2006 (IBRD 2007; World Bank 2007a). The HIPC Initiative launched in 1996 has committed \$62 billion (\$42 billion in end-2005 net present value terms) in debt relief for 30 highly indebted low-income countries, 25 of which are in Sub-Saharan Africa. The MDRI, launched in 2006, deepens this debt relief by providing 100 percent debt cancellation by the International Monetary Fund, International Development Association and the African Development Fund. This debt relief amounts to \$38 billion for a smaller group of 22 countries (18 of which are in Sub-Saharan Africa) that have reached, or will eventually reach, completion under the HIPC Initiative (IBRD 2006, 2007; World Bank 2007b). These two initiatives together have reduced debt-service to exports from 17 percent in 1998-99 to 4 percent in 2006 (IBRD 2007).

¹¹ The present value of debt stocks would eventually decline by 90 percent for the group of 30 HIPC countries. Lower debt stock ratios, however, may increase "free rider" risks. (IBRD 2007).

¹² Nigeria has benefited from both debt relief and the commodity price boom. Under an agreement with the Paris Club group of official creditors, Nigeria received \$18 billion in debt relief and used its oil revenues to prepay its remaining obligations of \$12.4 billion to the Paris Club creditors (and another \$1.5 billion to London Club creditors) during 2005-06. This has resulted in a reduction of Nigeria's external debt stock by more than \$30 billion (World Bank 2007a).

A new group of aid-donors—comprising Brazil, China, India, Lebanon, and Saudi Arabia—has emerged on the African scene. In January 2006, the Chinese government issued an official paper on China's Africa policy, and at the November 2006 China-Africa Summit, China promised to double its aid to Africa by 2009.¹³ The old relationship between India and Africa is now being refocused to deepen economic collaboration in the areas of trade, technology and training. Under the Indian Technical and Economic Cooperation Program, India spent more than \$1 billion on aid assistance, including training, deputation of experts and implementation of projects.

With traditional donors still failing to live up to their aid commitments, assistance from new donors could fill some of the funding gap in Sub-Saharan Africa. However, China's and India's approaches of de-linking aid from political and economic reforms have raised concerns among traditional donors. These new emerging donors could cause traditional aid institutions to lower their own standards regarding governance and environmental issues among others given that China and India have not been involved in the debates on aid effectiveness. In the future, the new aid-givers could participate in the global donor system.¹⁴

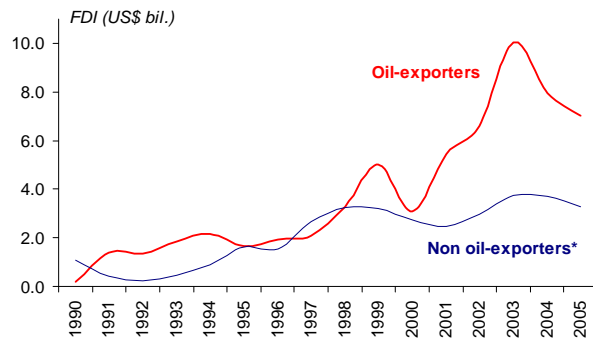
FDI flows to Sub-Saharan Africa were comparable to other regions, but appear to be mostly in enclave sectors

FDI to Sub-Saharan African countries reached an estimated \$17.1 billion in 2006, becoming the second largest source of external financing for the region. Low-income Sub-Saharan African countries received virtually all medium- and long-term private capital flows in the form of FDI. The region's improved macroeconomic management and growth performance, the commodity price boom and debt relief has resulted in more investor interest. FDI to Sub-Saharan African countries excluding South Africa more than doubled from 2000, reaching an estimated \$17.2 billion in 2006. Although the amount received by Sub-Saharan Africa is tiny compared with the total FDI flows to developing countries, as a share of GDP it is equivalent to 2.4 percent, comparable to the share of FDI in the GDP of other developing regions.

¹³ Speech by Chinese President Hu Jintao. Integrated Regional Information Networks, United Nations, November 6, 2006, <http://www.worldpress.org/africa/2554.cfm>

¹⁴ One first step in this direction has been the memorandum of understanding between the World Bank and the Export-Import Bank of China to improve cooperation in Africa. Initial cooperation would focus on infrastructure lending, in the transportation and energy sectors (Jim Adams, interview with Reuters, May 22, 2007).

Figure 2: FDI flows are larger in oil-exporting countries in Sub-Saharan Africa*



* Excluding South Africa

Source: Authors' calculations, *Global Development Finance* database, September 2007.

However, FDI flows to Sub-Saharan Africa appear to be concentrated in enclave sectors such as oil and natural resources (McDonald, Treichel, and Weisfeld 2006; World Bank 2007a). FDI flows to oil-exporting and commodities-exporting countries were larger than in other countries in the region from 1990 onwards (figure 2). Oil exporters received nearly 70 percent of FDI to going to Sub-Saharan African countries other than South Africa in 2005. Net FDI inflows to four major oil-producing countries in Sub-Saharan Africa—Angola, Equatorial Guinea, Nigeria, and Sudan—alone were estimated at \$10 billion in 2006, half of all FDI to low-income countries in 2006 (World Bank 2007a). Non-resource-intensive countries other than South Africa recorded rising but substantially lower inflows.

Private debt flows to Sub-Saharan Africa are small and short-term

Debt flows to Sub-Saharan African countries are small compared with other developing regions. Countries other than South Africa received an estimated \$-0.6 billion annually during 2005-06 in private medium and long-term debt flows, and \$ 2.8 billion in short-term debt flows (usually in the form of trade credits) during 2005-06, almost half of all short-term debt flows to the region. The high share of short-term debt in private debt flows reflects the high risk of lending on unsecured terms and at longer maturities to Sub-Saharan African firms. These short-term flows were relatively volatile and carry the risk of rapid reversal (see box 1).

Medium and long-term flows were mostly bank lending to middle-income Sub-Saharan African countries. One middle-income oil-exporting country, Angola, appears to account for virtually all of medium and long-term bank lending to Sub-Saharan African countries other than South Africa in 2003–05. More recent data on syndicated loans from the Loanware database

suggests that bank lending has grown since, but mainly in resource rich countries such as Angola, Liberia, Nigeria and Zambia.

Bond issuance in Sub-Saharan Africa was almost exclusively limited to South Africa until 2006. Low and middle-income Sub-Saharan African countries other than South Africa received negligible amounts of bond financing from international markets. More recently, Ghana issued \$750 million of international bonds in 2007, and several other Sub-Saharan African countries are considering international bond issues.¹⁵

Portfolio equity flows were almost absent in Sub-Saharan Africa excluding South Africa

Portfolio equity flows have increased since 1990 to an estimated \$15.1 billion in 2006 and are now an important source of external finance for Sub-Saharan Africa. However, portfolio flows have gone almost exclusively to South Africa (\$15 billion). When South Africa is excluded, portfolio equity flows are negligible in low- and middle-income Sub-Saharan African countries. Although South Africa has received more than \$4 billion annually, on average, since 1995, other Sub-Saharan African countries together received less than \$50 million annually during this period. Foreign investors appear to be averse to investing in Africa because of lack of information, severe risk perception, and the small size of the market that makes stocks relatively illiquid assets. One way to encourage greater private investment in these markets could be to tap into the diaspora outside Africa. Some initiatives being prepared by the diaspora is the formation of regional funds to be invested in companies listed on African stock markets.

Personal and institutional remittances are a growing source of external financing for Sub-Saharan Africa

Recorded personal remittance inflows to Sub-Saharan Africa have increased steadily during the last decade, from \$3.2 billion in 1995 to \$9.3 billion in 2005 and to \$10.3 billion in 2006. Most of this flow (\$8.5 billion) went to low-income Sub-Saharan African countries in 2006. Unrecorded flows through informal channels are believed to be even higher (World Bank 2005; Page and Plaza 2006).¹⁶ In six Sub-Saharan African countries—Botswana, Cote d'Ivoire, Lesotho, Mauritius, Swaziland and Togo—remittances were higher than ODA flows. In Lesotho, Mauritius, Swaziland and Togo, remittances were also greater than FDI.

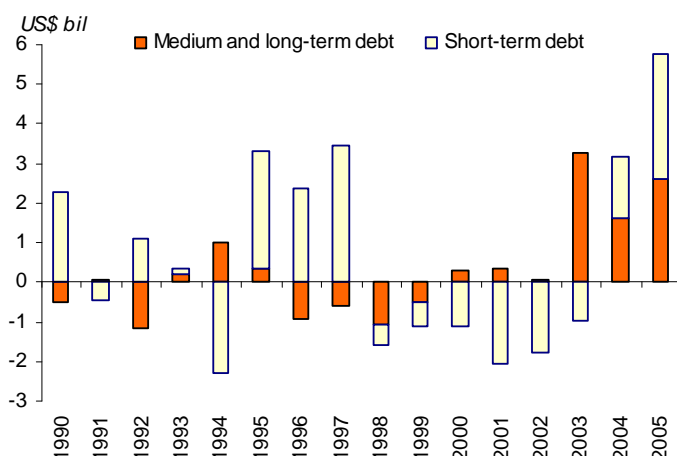
¹⁵ Ghana, which benefited from over \$4 billion in debt relief under the HIPC and MDRI, concluded a bond issue for \$750 million with a 10 year maturity and 387 basis point spread. The resources will finance infrastructure and development projects. Some of the other Sub-Saharan countries that are potential candidates for entering the international bond market include Kenya, Nigeria and Zambia, all three of which have seen significant increases in the non-resident purchases of domestic public debt in recent years (World Bank 2007a).

¹⁶ Page and Plaza (2006) estimate that 73 percent of remittances to Sub-Saharan African countries were through unofficial channels. Using this estimate, remittances to Sub-Saharan Africa through formal and informal channels would be more than \$30 billion annually.

Box 1: Reliance on Short-term Debt in Sub-Saharan Africa

Short-term debt comprises a large share of private debt flows to Sub-Saharan Africa.* Even as developing countries in other regions reduce their dependence on short-term debt, these flows continue to be a large and volatile component of private debt flows to Sub-Saharan Africa (see figure). After a surge in private short-term debt flows to Sub-Saharan Africa during the mid-1990s, these flows turned negative from 1998 to 2002 after the Asian financial crisis. They have again increased in recent years as Sub-Saharan Africa's growth performance improved. Since 1990, most private debt inflows into Sub-Saharan Africa have been short term.

Short-term debt has been a large and volatile component of private debt flows to Sub-Saharan Africa



Source: Authors' calculations, *Global Development Finance* database, September 2007.

The high share of short-term debt may be partly explained by the severe informational asymmetries and risk perceptions of investing in Sub-Saharan Africa. Similar factors also account for the dominance of foreign direct investment in private capital flows to Sub-Saharan Africa and the small share of arm's-length financing through bond issuance and portfolio equity. In situations characterized by high risks, investors typically prefer to take direct control of their investment through FDI (Hausman and Fernandez-Arias 2001) or resort to relationship-based bank lending that is typically short term or can be secured by some tangible collateral, such as trade credits (See box 2).

A reliance on short-term debt can be risky for the receiving countries. Short-term debt tends to be procyclical in developing countries, increasing when economic growth is cyclically faster and declining when growth rates falter (Dadush, Dasgupta, and Ratha 2000). Favorable conditions attract large inflows, encouraging potentially unsustainable levels of consumption and investment. Changes in risk perceptions, however, can lead to rapid reversals, imposing larger-than-necessary adjustment costs for the receiving countries.

* Short-term international debt is defined as cross-border debt falling due within a year. The original maturity concept followed by World Bank (2002) is used here. The Bank for International Settlements, however, uses a "remaining maturity" concept—that is, all cross-border debt falling due within one year is counted as short-term debt, regardless of its original maturity. (Dadush, Dasgupta, and Ratha 2000). Although conceptually different, the trends in the two are usually similar.

However, remittance flows to Sub-Saharan Africa have lagged behind other developing countries. Low-income countries received some \$56 billion or 3.5 percent of GDP as remittances in 2006, whereas Sub-Saharan African countries other than South Africa received 2.1 percent. The relatively low share of recorded remittances to Sub-Saharan Africa is almost certainly attributable to a high share of informal transfers.

Institutional remittances, which include grants by U.S and European foundations, were another category of resource flows that are large and growing steadily.¹⁷ Institutional remittances to Sub-Saharan Africa increased from less than \$2 billion in the early 1990s to \$6.3 billion by 2006. As with personal remittances, most institutional remittances went to the poorest countries, with low-income Sub-Saharan African countries receiving \$5.0 billion or 1.6 percent of GDP in 2005.

Private foundations, such as the Bill & Melinda Gates Foundation, are increasingly becoming important players in financing development. U.S. and European foundations provide some \$4.4 billion in grants annually for international development (Sulla 2007). However, most of the international assistance from U.S. foundations is channeled through global funds such as GAVI, international institutions, and international non-governmental organizations, and goes to emerging markets such as Brazil, China, India, Mexico, the Russian Federation, and South Africa, rather than the poorest countries in Sub-Saharan Africa where grants from the International Development Association (IDA) continue to play a dominant role.¹⁸ This may result partly from a lack of information and difficulties in implementing projects in the poorest countries in Sub-Saharan Africa.

Institutional remittances have become increasingly important for financing the most pressing development needs of Sub-Saharan Africa, including those essential for reaching the MDGs. However, some of the so-called vertical funds raise challenges because of their focus on specific issues, for example, diseases such as AIDS, tuberculosis, or malaria (see Sulla 2007 for recent trends and issues in grant giving by U.S. and European foundations). Multilateral institutions such as the IDA can help channel external assistance in a coordinated manner, provide support for broader sector-specific (education, health) strategies, and align these with Sub-Saharan African countries' own development priorities.

¹⁷ Institutional remittances consist of current and capital transfers in cash or in kind payable by any resident sector (that is, households, government, corporations, and nonprofit institutions serving households [NPISHs]) to non-resident households and NPISHs and receivable by resident households and NPISHs from any non-resident sector and excluding household to household transfers (United Nations Statistics Division 1998). NPISH is defined as a non-profit institution that is not predominantly financed and controlled by government and that provides goods or services to households free or at prices that are not economically significant.

¹⁸ IDA countries (mostly in Sub-Saharan Africa) received an estimated \$20 million from U.S. foundations in 2004, which was less than 3 percent of direct cross-border grants of \$800 million provided by U.S. foundations in that year (Sulla 2007).

Box 2. New Players in Sub-Saharan Africa

Emerging creditors such as China—and India on a smaller scale—have increased their financial involvement in Sub-Saharan Africa in the form of loans, grants, debt relief, and direct investment. Relevant data are not easily available, but China appears to be the largest of six new creditor nations. By May 2006, China had contributed \$5.7 billion for more than 800 aid projects (IMF 2007). In the latest Beijing Summit of the Forum on China-African Cooperation in November, 2006, China announced that it would provide \$5 billion on preferential credits for the period 2007-09 (\$ 3 billion in concessional loans and \$2 billion for export buyer credits). Counting media reports only, Export-Import Bank of China provided \$7 billion in the period 2004-06. In May 2007, Export-Import Bank of China stated that it planned to provide about \$20 billion in infrastructure and trade financing to Africa over the next three years (*Financial Times* 2007a). China's investment in oil and textiles has rapidly spiked upwardly in Angola, Sudan, and Zimbabwe. With the support of the Export Import Bank of China, Chinese companies have quickly become leaders in the development of roads, railroads, and major public buildings, as well as telecommunications on the continent (Broadman, Isik, Plaza, Ye, and Yoshino 2007). Chad and China just signed a \$257 million economic package to finance several projects in the central African country including telecommunications, a cement factory, and roads.

Chinese banks are also entering a new phase of involvement in Africa by developing partnerships with and buying equity stakes in African banks. The Industrial and Commercial Bank of China is acquiring 20 per cent of South Africa's Standard Bank for about \$5 billion (*Financial Times* 2007b). The two banks will jointly establish a global resources fund to invest in mining, metals, and oil and gas in emerging markets. China Development Bank has formed a partnership with Nigeria's United Bank for Africa to cooperate in financing energy and infrastructure projects in Nigeria and other West African countries (*Oxford Analytica* 2007).

China has offered debt forgiveness to 31 African countries, amounting to \$1.27 billion since 2000, and more write-offs are expected. By mid-May 2007, China had signed debt forgiveness agreements with 11 of those countries and expected to conclude agreements with the other 22 by the end of 2007 (Wang 2007).

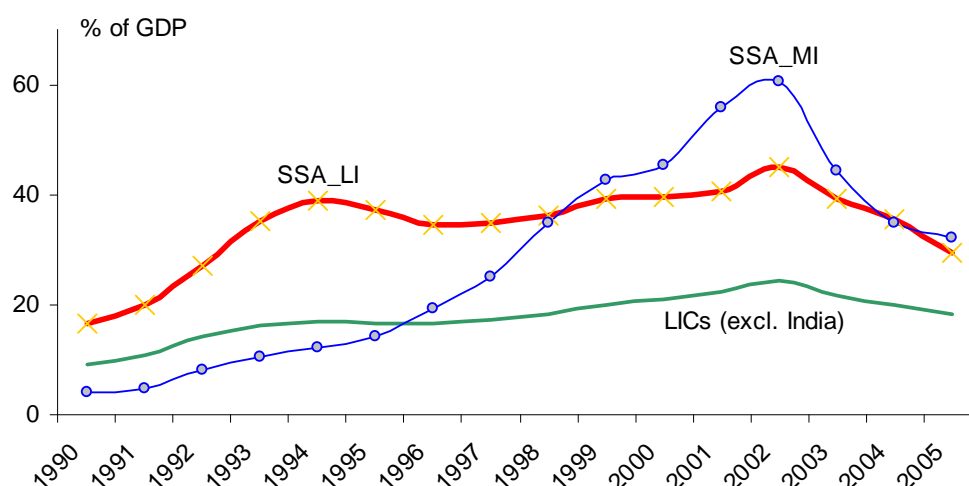
China's non-concessional loans to some countries have raised concerns that it may be free-riding in countries that received debt relief under the MDRI and the HIPC programs (*Economist* 2007). According to some authors, however, the majority of the projects undertaken by China are in non-HIPC resource-rich countries, such as Angola, Nigeria, and Sudan (Goldstein, Pinaud, Reisen and Chen 2006). In those countries, these loans are part of China's FDI directed to strategic resource seeking.¹⁹ A \$5 billion China-Africa Development Fund has been created to support Chinese FDI in Africa.

¹⁹ China and India's investments in Africa are examples of a broader South-South investment trend. Aykut and Ratha (2005) show that by the late 1990s, more than a third of FDI received by developing countries originated in other developing countries.

Capital outflows from Sub-Saharan Africa have decreased in recent years, but the stock of flight capital abroad remains high

Capital outflows from Sub-Saharan African countries averaged \$8.1 billion annually from 1990 to 2005.²⁰ Capital outflows from Sub-Saharan Africa increased until 2002 but have declined in recent years (figure 3). The cumulated stock of outflows from Sub-Saharan African countries was \$178 billion in 2006, nearly 30 percent of GDP—down from a high of 51 percent of GDP in 2002. Capital outflows increased faster from middle-income and resource-rich Sub-Saharan African countries in the 1990s, reaching 59 percent of GDP in 2002 (figure 3).²¹

Figure 3. Capital Outflows from Sub-Saharan Africa have declined recently



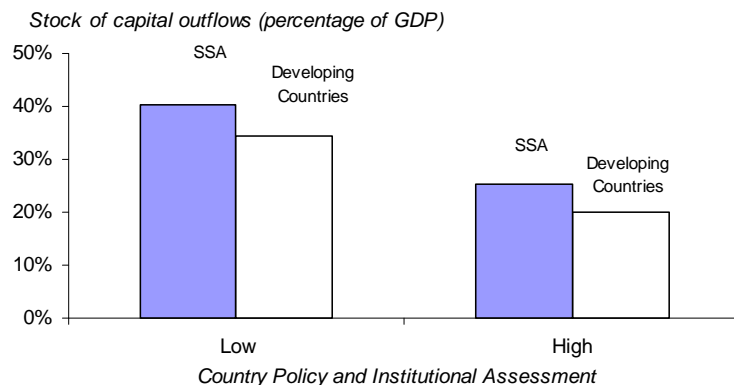
Source: Authors' calculations based on World Bank 2007a.

Several studies have identified a number of factors that encourage capital flight from Africa (see for example, Ajayi 1997; Boyce and Ndikumana 2001; Collier, Hoeffler, and Pattillo 2001; Hermes et al. 2002; Ndikumana and Boyce 2002; Powell, Ratha, and Mohapatra 2002; Salisu 2005; World Bank 2004). Some of the main determinants of capital flight include macroeconomic instability, political instability, external borrowing, risk-adjusted rates of return differentials, and financial development, among others. Consistent with the view of outflows as a portfolio diversification choice (Collier, Hoeffler, and Pattillo 2004), the stock of cumulated capital outflows appears to be negatively related to the country performance rating including corruption, economic management and transparency (figure 4).

²⁰ See Powell, Ratha and Mohapatra (2002) and World Bank (2002) for the construction of capital outflows as the difference between sources and uses of funds in the International Monetary Fund Balance of Payments Statistics.

²¹ Average annual capital outflows from Nigeria have been in the range of \$2.5 billion since the late 1980s.

Figure 4. A better policy environment reduces capital outflows



Source: Authors' calculations

There appears to have been capital flight reversal in the past few years. Improving macroeconomic fundamentals, better growth prospects, and an improving business environment have improved the risk-adjusted returns from investing domestically (see box 2).

3. New Sources and Innovative Mechanisms for Financing Development in Sub-Saharan Africa

This section discusses some new or hitherto-overlooked sources and some innovative structures for development financing in Sub-Saharan African countries. First, the section discusses two new sources of financing: issuance of diaspora bonds and efforts to increase migrant remittances by reducing money transfer costs. The section then discusses some recent initiatives that involve innovative financial structures—multilateral guarantees that leverage official financing for mobilizing private capital and the IFFIm that front-loads aid commitments—before describing a more generalized financial structuring that allows private entities to issue debt backed by future remittances and other future-flow receivables. Finally, the section argues for establishing sovereign credit ratings for Sub-Saharan countries, because ratings are key to attracting private capital.

New sources of financing

Diaspora bonds

A diaspora bond is a debt instrument issued by a country—or, potentially, by a sub-sovereign entity or by a private corporation—to raise financing from its overseas diaspora. India and Israel have raised \$11 billion and \$25 billion, respectively, from their diaspora abroad (Ketkar and Ratha 2007). The diaspora usually have more information about their country of origin. These bonds are issued often in times of crisis and often at a “patriotic” discount. Unlike

international investors, the diaspora tend to be less averse to convertibility risk because they are likely to have current and contingent liabilities in their home country. Further, the diaspora usually have a strong desire to contribute to the development of their home country and are therefore more likely to purchase diaspora bonds.

Table 2: Potential market for diaspora bonds

	Diaspora stock ('000)	Potential diaspora saving (\$ bil.)
South Africa	713	2.9
Nigeria	837	2.8
Kenya	427	1.7
Ghana	907	1.7
Ethiopia	446	1.6
Somalia	441	1.6
Senegal	463	1.3
Zimbabwe	761	1.0
Sudan	587	1.0
Angola	523	1.0
Congo, Dem. Rep.	572	0.8
Cape Verde	181	0.7
Uganda	155	0.7
Mauritius	119	0.7
Cameroon	231	0.6
Mozambique	803	0.6
Madagascar	151	0.6
Tanzania	189	0.6
Eritrea	849	0.6
Mali	1,213	0.6
Other SSA countries	5,285	5.5
Total	15,854	28.5

* Diaspora stocks for 2005 includes only identified migrants from Ratha and Shaw (2007). Diaspora savings are calculated assuming migrants earned the average per capita income of the host country and saved one-fifth of their income. Under the alternative scenario of African migrants earning half of the per capita income in the host countries and saving a fifth of their income, the potential annual saving of the African diaspora would be over \$10 billion.

Source: Authors' calculations.

Table 2 shows estimates of the diaspora stocks of Sub-Saharan African countries and their annual savings. The stock of Sub-Saharan African diaspora is estimated to be about 16 million, with 5 million in high-income countries. Assuming that members of the Sub-Saharan African diaspora earn the average income of their host countries and save a fifth of their income, their annual savings would be more than \$28 billion. Most of these savings would come from the migrants in the OECD countries, where a third of Sub-Saharan African diaspora are located, due to the larger income differentials. In an alternative scenario, if the Sub-Saharan African diaspora were assumed to earn half the average per capita income in the host countries and saved only 20 percent of their income, the annual savings of the African diaspora would still be over \$10

billion. Presently the bulk of this saving is invested outside Africa. African governments and private corporations can potentially tap into these resources by issuing diaspora bonds. Diaspora bonds can also provide an instrument for repatriation of Africa's flight capital, estimated at more than \$170 billion (as discussed). Diaspora bonds could potentially raise \$5 billion to 10 billion annually by tapping into the wealth of the African diaspora abroad and the flight capital held abroad by its residents.²²

While the size of the potential market for diaspora bonds is indeed impressive, it may be difficult for some unrated Sub-Saharan African countries that are characterized by high risks to issue diaspora bonds. Some of the constraints that Sub-Saharan African countries may face in issuing diaspora bonds include weak and non-transparent legal systems for contract enforcement; a lack of national banks and other institutions in destination countries, which can facilitate the marketing of these bonds; and a lack of clarity on regulations in the host countries that allow or constrain diaspora members from investing in these bonds (Chander 2001; Ketkar and Ratha 2007). However, because of recent debt relief initiatives and improving macroeconomic management, many Sub-Saharan African countries are in a better position to access private capital markets than anytime in recent decades.

Reducing remittance costs

Reducing remittance costs would increase remittance flows to Sub-Saharan Africa. Sub-Saharan Africa is believed to have the highest share of remittances flowing through informal channels among all regions (Page and Plaza 2006).²³ This is partly because of the high cost of sending remittances in Sub-Saharan Africa. For example, the average cost, including foreign exchange premium, of sending \$200 from London to Lagos, Nigeria, in mid-2006 was 14.4 percent of the amount, and the cost from Cotonou, Benin, to Lagos was more than 17 percent (Ratha and Shaw 2007). Reducing remittance fees would increase the disposable income of remitters, encouraging them to remit large amounts and at greater frequencies. It would also encourage remittance senders to shift from informal to formal channels.

Estimating the additional remittance flows that would result from a decrease in remittance cost is complicated by several factors. For example, remittances sent for an immediate family emergency may not be responsive to costs. However, estimates based on surveys of Tongan migrants indicate the cost elasticity to be in the range of .22, that is, a 1 percent decrease in cost would increase remittances by 0.22 percent (Gibson, McKenzie, and Rohorua 2006). For example, halving remittance costs from the current high levels, from 14

²² South Africa is reported to have launched a project to issue Reconciliation and Development (R&D) bonds to both expatriate and domestic investors (Bradlow 2006). Ghana has begun marketing the Golden Jubilee Savings Bond to the Ghanaian diaspora in Europe and the United States.

²³ Page and Plaza (2006) estimate that almost three-quarter of remittances to Sub-Saharan African Africa were through unofficial channels.

percent to 7 percent for the London-Lagos corridor, would thus increase remittances by 11 percent. This change implies additional remittance flows of more than \$1 billion every year. Assuming that the reduction in remittance cost also succeeds in bringing half the unrecorded remittances into formal channels, this would result in an increase in recorded remittances flows to Sub-Saharan Africa of \$2.5 billion.

Remittances costs faced by poor migrants from Sub-Saharan African countries can be reduced by improving the access to banking for remittance senders and recipients and by strengthening competition in the remittance industry (Ratha 2007, World Bank 2005). Clarifying regulations related to anti-money laundering and the countering the financing of terrorism and avoiding overregulation, such as requiring a full banking license for specialized money transfer operators, would facilitate the entry of new players. It would also encourage the adoption of more efficient technologies such as the use of internet and mobile phone technology. Sharing payment platforms and non-exclusive partnerships between remittance service providers and existing postal and retail networks would help expand remittance services without requiring large fixed investments.

Innovative structuring

Guarantees

World Bank and IDA partial risk guarantees of some \$3 billion were successful in catalyzing \$12 billion in private financing in 28 operations in developing countries during the last decade (Gelb, Ramachandran and Turner 2006). These typically cover project financing in large infrastructure projects and other sectors with high social returns. World Bank guarantees include partial risk guarantees and partial credit guarantees that cover private debt for large public projects (typically infrastructure). Although the former typically cover the risk of nonperformance of sovereign contractual obligations, the latter cover a much broader range of credit risks and are designed to lower the cost and extend the maturity of debt (Matsukawa and Habeck 2007).²⁴ Political risk guarantees issued by the Multilateral Investment Guarantee Agency (MIGA) have helped alleviate political and others risks in agribusiness, manufacturing and tourism. The African Export-Import Bank and other agencies provide guarantees for trade credits (See box 3). There appears to be potential to increase the use of IDA guarantees beyond large infrastructure projects to small and medium enterprises.

²⁴ Partial risk guarantees have been typically provided for private-sector projects in all countries, including IDA-eligible poor countries, and partial credit guarantees usually to public investment project in countries eligible for IBRD loans. In addition, policy based guarantees are extended to help well-performing IBRD-eligible governments access capital markets.

Box 3: Trade Finance as an Attractive Short-term Financing Option

Trade finance is an attractive way of increasing short-term financing to risky African countries in the presence of asymmetric information. Firms operating in international markets require financing for the purchase of their imports and for the production of their exports. Many African firms, however, have no access to trade finance or instruments to support their operations because of information asymmetries and their perceived greater risk. Larger firms that have access to credit from importers, the banking system (typically from affiliates of European global banking corporations whose core business is often short-term trade finance), or other non-bank financial institutions often provide trade credit to their smaller suppliers, who in many cases have no access to credit.

In recent years, the export credit agencies of China and India have become increasingly prominent in promoting trade finance in Sub-Saharan Africa, not only for raw materials, commodities, and natural resources, but also for capital goods (machinery, equipment) and manufactured products. In 2006, the Export-Import Bank of India extended a \$250 million line of credit to ECOWAS Bank for Investment and Development (EBID) to finance India's exports to the 15 member countries of EBID. It has also previously extended trade financing to the Eastern and Southern African Trade and Development Bank (PTA Bank) for \$50 million to promote India's exports to 16 eastern and southern African countries. The Export-Import Bank of China is financing a larger set of activities, providing export credit, loans for construction contracts and investment projects (including energy and communication projects), and concessional loans and guarantees.

The World Bank is supporting an innovative project through its Regional Trade Facilitation Program to address the gaps in the private political and credit risk insurance market for cross-border transactions involving African countries. The project is managed by the African Trade Insurance Agency (ATI), a multilateral agency set up by treaty, and brings together a group of countries in the southern and eastern African regions to develop a credible insurance mechanism. To date, ATI has facilitated \$110.7 million in trade and investments in ATI member countries, using only \$21.6 million of IDA resources—a gearing ratio of almost five to one in sectors that include mining (Zambia), housing (the Democratic Republic of Congo), flowers (Kenya), and telecommunications (Burundi and Uganda). Clients have indicated that without ATI's support, they might not have received the necessary financing.

Although trade finance can facilitate trade and economic linkages with Africa's major trading partners, Africa needs additional longer-term sources of external finance. Trade finance is typically short term and carries many risks associated with short-term debt (see box 1). The recent expansion of trade finance may also partly reflect the inability of Sub-Saharan African countries to obtain unsecured financing at longer maturities. Enhancing the scope and volume of trade finance can facilitate trade and improve regional economic cooperation, but additional external resource flows are required to finance the projects in infrastructure, manufacturing, education and health that have high social returns and involve significantly longer time horizons.

The first-ever IDA partial risk guarantee in Sub-Saharan Africa in 1999 for the Azito power project in Côte d'Ivoire catalyzed private financing of \$200 million while keeping IDA support to \$30 million, or 15 percent of the project (World Bank 1999). IDA partial risk guarantees are under preparation for the 250 megawatt Bujagali hydropower project in Uganda, a 50 megawatt hydropower project in Sierra Leone, and a project to increase power sector efficiency in Senegal (World Bank 2007c).

There is potential for extending the scope and reach of guarantees to use aid resources to catalyze large volumes of private financing in Sub-Saharan Africa beyond the traditional large infrastructure projects and beyond sovereign borrowers. Gelb, Ramachandran and Turner (2006) suggest that guarantees should be available not only to foreign investors but also to domestic investors including pension and insurance funds, to raise local currency financing. Guarantee facilities can be established to support several small projects in the same sector, similar to a “master trust” arrangement. Innovations include service guarantees that can protect investors against service failures in areas such as power, customs, and licensing that discourage private investment in Sub-Saharan African countries.

IFFIm, AMC and other innovative structuring by public-private partnerships

Several international initiatives are underway for innovative development financing mechanisms. They include a search for new sources of financing, innovative ways of realizing future commitments, and innovative ways of using existing resources. The IFFIm is an innovative structuring mechanism for realizing future aid commitments to introduce more reliable and predictable aid flows for immunization programs and health system development for GAVI.²⁵ IFFIm raised \$1 billion in 2006 and plans to raise \$4 billion more during the next 10 years by 'securitizing'—in other words, front-loading—future aid commitments from several donor countries (France, Italy, Norway, South Africa, Spain, Sweden, and the United Kingdom). The donor countries have signed legally binding agreements with the GAVI Fund Affiliate to provide future grants to IFFIm, which issues the bonds in international markets. IFFIm disburses the proceeds as required for GAVI-approved programs to procure needed vaccines and to strengthen the health systems of recipient countries. Future grant flows from donors are used to repay bondholders. The backing of highly creditworthy developed country donors has enabled IFFIm to issue AAA rated bonds in international capital markets at competitive spreads.

Such a facility, however, faces several constraints, including the question of “additionality” (whether the countries that bought the bonds will reduce aid), high transaction costs, and whether the coupon yield will be paid for by sovereign bond guarantors or subtracted from the proceeds.

The Advanced Market Commitment (AMC) for vaccines launched in February 2007 is another innovative structuring mechanism that would complement the efforts of IFFIm by providing financial incentives to accelerate the development of vaccines important to developing countries. The donors provide up-front financing for the AMC, which negotiates with the

²⁵ The Global Alliance for Vaccines and Immunization (GAVI), a public-private partnership for combating disease, was created in 1999 and has received grant commitments of \$1.5 billion from the Gates Foundation, with additional contributions coming from Australia, Brazil, Canada, France, Germany, Denmark, Ireland, Luxembourg, the Netherlands, Norway, South Africa, Spain, Sweden, the US, UK, EU, and the World Bank. See www.gavialliance.org.

pharmaceutical industry to provide a set level of funding in return for future supply at an agreed price for the manufacturer that first develops the vaccine (GAVI and World Bank 2006). Canada, Italy, Norway, Russia, the United Kingdom, and the Gates Foundation have provided \$1.5 billion for the pilot AMC to develop a vaccine for pneumococcal disease which causes 1.9 million child deaths a year. The AMC is not expected to increase aid flows substantially to poor countries, but it brings together public and private donors in an innovative way to help meet the MDGs (IBRD 2007).²⁶

Other public-private partnerships to generate new sources of innovative financing that are under consideration include a currency transaction levy, airline and environmental taxes and private contributions.²⁷ Introducing a one basis point levy on currency transactions could yield over \$16 billion in revenue annually, according to Hillman, Kapoor and Spratt (2006). This variation of a Tobin tax, however, is not popular with the financial institutions, nor with countries that are major financial centers. Such taxes would cause friction in financial transactions and have cascading effects. Airline taxes are already being implemented in some countries (e.g., eight countries including France have raised \$250 million in 2007), but there are questions as to whether these were new taxes (IBRD 2007).²⁸

These public-private partnerships, however, rely on donor government efforts to mobilize financing and are subject to the same concerns about aid allocation, coordination and effectiveness. These innovative projects are not designed for catalyzing private-to-private flows to developing countries from the international capital markets.

A new initiative by the World Bank Group—the Global Emerging Markets Local Currency (Gemloc) Bond Fund announced in October 2007—proposes to raise \$5 billion from international capital markets to invest in local-currency bond markets in developing countries.²⁹ The Gemloc public-private partnership will mobilize local-currency denominated resources for governments in selected emerging market countries, thereby eliminating the devaluation risk associated with foreign-currency borrowing. Corporate bonds will be included subsequently, but at least 70 percent of the proceeds of Gemloc would be invested in local-currency bonds issued by sovereign and quasi-sovereign entities.

²⁶ Birdsall and Subramanian (2007) argue that international financial institutions have traditionally under-funded the provision of global public goods (GPGs) and have not been adequately involved in the development of new GPG products such as the AMC, preferring instead to provide loans and grants to individual countries.

²⁷ See Skare (2007), Trepelkov (2007), and the discussions of the Second and the Third Plenary Meetings of the Leading Group on Solidarity Levies to Fund Development established in March 2006. (<http://www.innovativefinance-oslo.no/recommendedreading.cfm>, and <http://www.innovativefinance.go.kr>). Among the innovative financing projects, 28 countries of the Leading Group are considering introduction of an Air Ticket Solidarity Levy to funding for improving access to treatments against HIV/AIDS, TB and malaria through the International Drug Purchase Facility, UNITAID.

²⁸ The solidarity levy on airline tickets has been implemented by France, Chile, Côte d'Ivoire, Congo, Republic of Korea, Madagascar, Mauritius and Niger. (See www.unitaid.eu)

²⁹ See www.gemloc.org for further details.

The creation of an independent and transparent benchmark index and “investability” rankings of countries’ local-currency bonds markets are expected to facilitate external financing flows to emerging markets. Like portfolio equity flows, however, the Gemloc is likely to favor middle-income countries with market access. Although the Gemloc plans to include Kenya, Nigeria and West African countries in a subsequent phase, most of the countries selected for the first phase (for example, Brazil, China, India and South Africa) are countries with sovereign ratings in the BB or BBB category. It is also not entirely clear whether the Gemloc would result in additional funding or whether it might substitute portfolio equity flows.³⁰

Future-flow securitization

Sub-Saharan African countries can potentially raise significant bond financing by using securitization of future-flows, such as remittances, tourism receipts and export receivables. Securitization of future hard-currency receivables is a potential means of improving the access of Sub-Saharan African countries to international capital markets. In a typical future-flow transaction, the borrower pledges its future foreign-currency receivables—for example, oil, remittances, credit card receivables, airline ticket receivables—as collateral to a special purpose vehicle (Ketkar and Ratha 2001, 2005). The special purpose vehicle issues the debt. By a legal arrangement between the borrowing entity and major international customers or correspondent banks, the future receivables are deposited directly in an offshore collection account managed by a trustee. The debt is serviced from this account, and excess collections are forwarded to the borrowing entity in the developing country.³¹

This future flow securitization mitigates sovereign transfer and convertibility risks and allows the securities to be rated better than the sovereign credit rating. These securities are typically structured to obtain an investment grade rating. For example, in the case of El Salvador, the remittance-backed securities were rated investment grade, two to four notches above the sub-investment grade sovereign rating. Investment-grade rating makes these transactions attractive to a wider range of “buy-and-hold” investors (for example, insurance companies) that face limitations on buying sub-investment grade. As a result, the issuer can access international capital markets at a lower interest rate spread and longer maturity. Moreover, by establishing a

³⁰ Under a more recent proposal advocated by the World Bank, sovereign wealth funds which are estimated to hold more than \$3 trillion in assets would be encouraged to invest 1 percent of that in Sub-Saharan Africa. This proposed “one percent” initiative would use the GEMLOC bond index and investability rankings (as well as promote the development of other market-based indices) to encourage investments by sovereign wealth funds in African markets. If successful, this would translate into \$30 billion of additional resource flows to African countries.

³¹ Such transactions also often resort to excess coverage to mitigate the risk of volatility and seasonality in future flows.

credit history for the borrower, these deals enhance the ability to obtain and reduce the costs of accessing capital markets in the future.³²

We estimate the potential size of future flow securitizations for various kinds of flows, including remittances, for Sub-Saharan Africa based on the methodology of Ketkar and Ratha (2001, 2005) using an over-collateralization ratio of five to one and average flows in 2003-06. These calculations indicate that the potential future flow securitization is \$17 billion annually, with remittance securitization alone in the range of \$2 billion (table 3). These include only the securitization of remittances recorded in the balance of payments. The actual unrecorded remittances through formal and informal channels are estimated to be a multiple in several countries (Page and Plaza 2006).

Remittances are a large and stable source of external financing that can be creatively leveraged for Sub-Saharan Africa's development goals. Remittances can improve capital market access of banks and governments in poor countries by improving ratings and securitization structures (Ratha 2006). Hard currency remittances, properly accounted, can significantly improve a country's risk rating. It may even encourage many poor countries that are currently not rated to obtain a credit rating from major international rating agencies (see the following for more discussion).

Table 3: Securitization potential in Sub-Saharan Africa (US\$ billion)

	Sub-Saharan Africa		Low income (excl. India)		All developing	
	Receivable (\$ bil.)*	Potential securitization (\$ bil.)	Receivable (\$ bil.)*	Potential securitization (\$ bil.)	Receivable (\$ bil.)*	Potential securitization (\$ bil.)
Fuel exports*	44.1	8.8	47.7	9.5	417.5	83.5
Agricultural raw materials exports*	5.7	1.1	4.4	0.9	46.3	9.3
Ores and metals exports*	13.4	2.7	5.0	1.0	106.6	21.3
Travel services**	12.4	2.5	4.8	1.0	168.5	33.7
Remittances**	8.4	1.7	23.6	4.7	179.4	35.9
Total	84.0	16.8	85.5	17.1	918.3	183.7

* Average for 2003-05; ** average for 2003-06.

Source: Authors' calculations using over-collateralization ratio of 5:1. Data on exports are from the World Bank's World Development Indicators. Worker remittances, defined as in Ratha (2003), are calculated from the IMF's Balance-of Payments Statistics Yearbook 2007.

The African Export-Import Bank (Afreximbank) has been active in facilitating future flow securitization since the late 1990s. In 1996, it co-arranged the first ever future-flow

³² Obtaining a rating is important for raising not only bond financing or bank loans, but also foreign direct investment and even official aid (Ratha, De and Mohapatra 2007). Any improvement in sovereign rating is likely to translate into an improvement in the rating of sub-sovereign borrowers whose foreign currency borrowing is typically subject to the sovereign rating ceiling.

securitization by a Sub-Saharan African country, a \$40 million medium-term loan in favor of a development bank in Ghana backed by its Western Union remittance receivables (Afreximbank 2005, Rutten and Oramah 2006). The bank launched its Financial Future-flow Pre-financing Programme in 2001 to expand the use of migrant remittances and other future flows—credit card and checks, royalties arising from bilateral air services agreements over flight fees, and so forth—as collateral to leverage external financing to fund agricultural and other projects in Sub-Saharan Africa. In recent year, the Afreximbank has arranged a \$50 million remittance-backed syndicated note issuance facility in favor of a Nigerian entity using Moneygram receivables in 2001, and it co-arranged a \$ 40 million remittance-backed syndicated term loan facility in favor of an Ethiopian bank using its Western Union receivables in 2004 (Afreximbank 2005).

There are, however, several institutional constraints to future-flow securitization in Sub-Saharan Africa. A low level of domestic financial development; lack of banking-relationships with banks abroad; and high fixed costs of legal, investment banking, and credit-rating services, especially in poor countries with few large entities, make the use of these instruments especially difficult for Sub-Saharan countries. Absence of an appropriate legal infrastructure and weak protection of creditor rights (including inadequate or poorly-enforced bankruptcy laws) and a volatile macroeconomic environment can also pose difficulties. In the case of remittance securitization, extensive use of informal channels in Sub-Saharan Africa can reduce the flows through the formal financial system and thereby the size of potential securitization.

Securitization by poor countries carries significant risks—currency devaluation and, in the case of flexible rate debt, unexpected increases in interest rates—that are associated with market-based foreign currency debt (World Bank 2005). Securitization of remittances (and other future flows) by public sector entities reduces the government’s flexibility in managing its external payments and can conflict with the negative pledge provision included in multilateral agencies’ loan and guarantee agreements, which prohibit the establishment of a priority for other debts over the multilateral debts.

Still, this asset class can provide useful access to international capital markets, especially during liquidity crises. Moreover, for many developing countries securitization backed by future flows of receivables may be the only way to begin accessing such markets. Given the long lead times involved in such deals, however, issuers need to keep securitization deals in the pipeline and investors engaged during good times so that such deals remain accessible during crises.

Recovery of stolen assets

Other innovative ways of using existing resources include recovery of flight capital and stolen assets. The cross-border flow of the global proceeds from criminal activities, corruption,

and tax evasion are estimated to be more than \$1 trillion annually.³³ Some \$20 billion to \$40 billion in assets acquired by corrupt leaders of poor countries, mostly in Africa, are kept overseas. The World Bank and the United Nations Office of Drugs and Crime have launched the Stolen Assets Recovery (StAR) initiative to help countries recover their stolen assets. This initiative will help countries establish institutions that can detect and deter illegal flow of funds, work with the Organisation for Economic Cooperation and Development countries in ratifying the Convention against Corruption, and support and monitor the use of recovered funds for development activities. These recovered assets could provide financing for social programs and infrastructure.³⁴

Establishing and improving sovereign ratings can facilitate market access

Sovereign risk ratings not only affect investment decisions in the international bond and loan markets, but they also affect allocation of FDI and portfolio equity flows (Ratha, De and Mohapatra 2007). The allocation of performance-based official aid is also increasingly being linked to sovereign rating. The foreign currency rating of the sovereign typically acts as a ceiling for the foreign currency rating of sub-sovereign entities. Even when the sovereign is not issuing bonds, a sovereign rating provides a benchmark for the capital market activities of the private sector.

Borrowing costs rise exponentially with a lowering of the credit rating (figure 5). There is also a threshold effect when borrowing spreads jump up as the rating slides below the investment grade (Ratha, De and Mohapatra 2007). A borrowing entity with a low credit rating, therefore, can significantly improve borrowing terms (that is, lower interest spread and increase maturity) by paying up front for a better credit rating.

Only 21 Sub-Saharan African countries had been rated by a major international rating agency as of December 2007 (Table 4).³⁵ The average rating of Sub-Saharan African countries remains low compared with other regions, restricting the access of their private sector to international capital. As noted in the previous section, private debt and equity flows to Sub-Saharan African countries were the lowest among all regions. Some authors have pointed to the

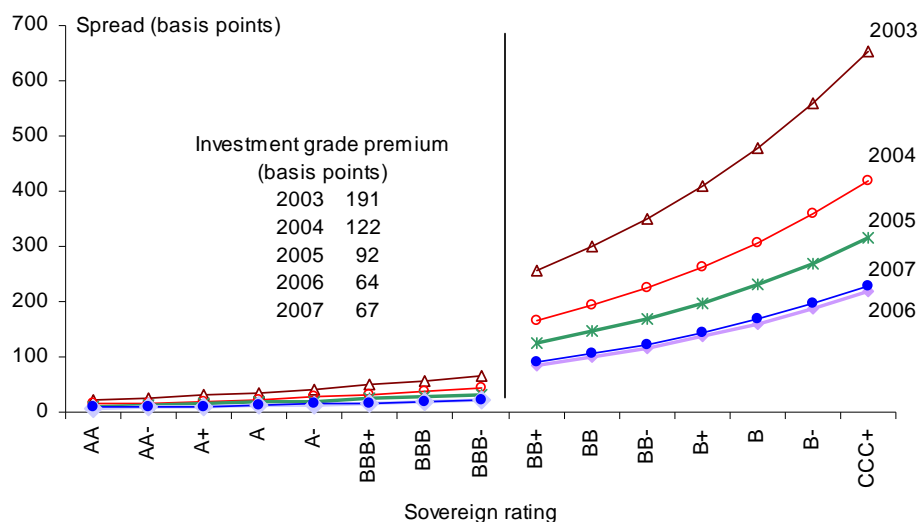
³³ “Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities, and Action Plan.” UNODC and World Bank. September 2007. (<http://siteresources.worldbank.org/NEWS/Resources/Star-rep-full.pdf>). 25 percent of GDP of African states is estimated to be lost to corruption every year, with corrupt actions encompassing petty bribe-taking done by low level government officials to inflated public procurement contracts, kickbacks, and raiding the public treasury as part of public asset theft by political leaders.

³⁴ For example, Nigeria has been successfully recovered half a billion dollars in stolen assets from Swiss sources with cooperation of the World Bank, civil society and the Swiss authorities.

³⁵ Ratha, De and Mohapatra (2007) argue that several factors may make it difficult for poor countries to get rated. The information required for the rating process can be complex and not readily available in many countries. The institutional and legal environment governing property rights and sale of securities may be absent or weak, prompting reluctance on the part of politicians to get publicly “judged” by the rating analysts. The fact that the country has to request a rating, and has to pay a fee for that, but has no say over the final rating outcome can also be discouraging.

existence of an “Africa premium”—equivalent to roughly 2 rating notches or 200 basis points—even for relatively better-performing countries with above-median growth and low aid-dependence (Gelb, Ramachandran and Turner 2006).

Figure 5. Launch spreads decline with an increase in sovereign rating*



* Assuming \$100 million sovereign bond issue with a 7 years tenor. Borrowing costs have fallen steadily since 2003 with a slight reversal more recently reflecting changes in the global liquidity situation. The investment grade premium indicates the rise in spreads when rating falls below BBB-. The relationship between sovereign ratings and spreads is based on the following regression: $\log(\text{launch spread}) = 2.58 - 1.2 \text{ investment grade dummy} + 0.15 \text{ sovereign rating} + 0.23 \log(\text{issue size}) + 0.03 \text{ maturity} - 0.44 \text{ year 2004 dummy} - 0.73 \text{ year 2005 dummy} - 1.10 \text{ year 2006 dummy} - 1.05 \text{ year 2007 dummy}$; $N = 200$; Adjusted $R^2 = 0.70$. All the coefficients were significant at 5 percent. A lower numeric value of the sovereign rating indicates a better rating.

Source: Ratha, De and Mohapatra (2007) based on Bondware and Standard and Poor's.

At the sub-sovereign level, few firms in Sub-Saharan Africa outside of South Africa are rated by the three international rating agencies.³⁶ Several firms are highly creditworthy in local currency terms but they are constrained by either an absent or low foreign currency sovereign rating.

Model-based estimates indicate that several unrated Sub-Saharan African countries would be rated higher than currently believed. Drawing on the well-established literature on the empirical determinants of sovereign ratings, Ratha, De, and Mohapatra (2007) find that the

³⁶ Only 5 banks in all of Sub-Saharan Africa excluding South Africa (4 in Nigeria and 1 in Mauritius) were in Standard and Poor's global debt issuers list. In contrast, South Africa had nearly 30 firms and banks in the list.

predicted or shadow sovereign ratings for several Sub-Saharan African countries that are currently unrated are in a similar range as some established emerging markets (table 5).³⁷

Table 4: Rated Sub-Saharan African countries (December 2007)

	S&P		Moody's		Fitch		Predicted shadow rating*
	Rating	Date	Rating	Date	Rating	Date	
Botswana	A	Apr 2001	Aa3	May 2006			AA to AAA
South Africa	BBB+	Aug 2005	Baa1	Jan 2005	BBB+	Aug 2005	BBB to BBB+
Mauritius			Baa1	May 2006			BBB+ to A-
Namibia					BBB-	Dec 2005	BBB- to BBB
Lesotho					BB-	Nov 2005	BB to BB+
Gabon	BB-	Nov 2007			BB-	Oct 2007	BBB- to BBB
Nigeria	BB-	Feb 2006			BB-	Jan 2006	BB to BBB-
Cape Verde					B+	Aug 2003	BBB-
Ghana	B+	Sep 2003			B+	Sep 2007	BB- to BB
Kenya	B+	Sep 2006					B to B+
Senegal	B+	Dec 2000					BB to BB+
Seychelles	B	Sep 2006					BB to BBB-
Cameroon	B	Feb 2007			B	Jun 2006	BB- to BB
Benin	B	Sep 2006			B	Sep 2004	BB- to BB
Burkina Faso	B	Mar 2004					B to B+
Madagascar	B	May 2004					B to B+
Mozambique	B	Jul 2004			B	Jul 2003	B+ to BB-
Uganda					B	Mar 2005	BB-
Mali	B	May 2004			B-	Apr 2004	BB
Malawi					B-	Mar 2007	CCC+ to B
The Gambia					CCC	Dec 2005	B+ to BB-

* These shadow ratings are based on forecasts of explanatory variables for 2007 for the benchmark sovereign rating model of Ratha, De and Mohapatra (2007). Source: Rating from Standard and Poor's, Moody's and Fitch.

Sub-Saharan African countries with large remittance inflows can leverage those inflows for raising the sovereign rating (Ratha 2006). Preliminary estimates indicate that including remittances in the debt-to-exports ratio in creditworthiness assessments would result in an improvement in sovereign ratings by up to two notches (World Bank 2005a). The securitization of future receivables, including trade payments and future remittances, can further improve the rating of the transaction, typically to investment grade (BBB). For example, the spread saving from improving ratings from B to BBB would be in the range of 320 to 450 basis points (figure 5).

³⁷ This literature models sovereign ratings as a function of macroeconomic and institutional variables (See Cantor and Packer 1995, Mora 2006). Interestingly, the benchmark model of Ratha, De and Mohapatra (2007) performs quite well for Sub-Saharan African countries. The predicted or shadow ratings for the 11 Sub-Saharan African countries rated under the recent United Nations Development Programme (UNDP) initiative were within one to two notches of the actual rating assigned by Standard and Poor's, as of the end of 2006. The model successfully predicted the rating of the recent bond issue from Ghana.

Table 5: Shadow sovereign ratings for unrated countries in Sub-Saharan Africa (December 2007)

	Predicted shadow rating*	Rated countries in the same range
Equatorial Guinea	BBB- to BBB	Mexico; India; Romania
Angola	BB+	El Salvador; Peru
Swaziland	BB- to BB+	Brazil; Turkey; Peru
Zambia	BB- to BB	Brazil; Turkey
Tanzania	BB-	Turkey; Uruguay
Congo, Rep.	B+ to BB-	Pakistan; Turkey
Niger	B- to B	Argentina; Bolivia; Paraguay
Rwanda	B- to B	Argentina; Bolivia; Paraguay
Togo	CCC+ to B-	Bolivia; Ecuador; Paraguay
Mauritania	CCC to B	Dominican Rep.; Ecuador
Cote d'Ivoire	CCC to B	Dominican Rep.; Ecuador
Sierra Leone	CCC to B	Ecuador; Pakistan
Ethiopia	CCC to CCC+	Ecuador
Sudan	CCC- to CCC+	Ecuador
Comoros	CCC- to CCC+	Ecuador
Congo, Dem. Rep.	CCC- to CCC	Ecuador
Guinea	CC to CCC	Ecuador
Chad	C to CCC+	Ecuador
Guinea-Bissau	C to CC	
Zimbabwe	C or lower	

* Shadow ratings use forecasts of explanatory variables for 2007 for the benchmark sovereign rating model of Ratha, De and Mohapatra (2007).

Source: Rating from Standard and Poor's, Moody's and Fitch.

Sub-Saharan African countries that received debt relief and improved their macroeconomic management appear to be better positioned to access international markets. Debt relief under the HIPC Initiative and under the MDRI has reduced the external debt-service obligations for 16 countries in Sub-Saharan Africa. Since mid-2005, private foreign investors have started acquiring government debt in local currencies in Sub-Saharan Africa (IMF, 2006). Investors have been attracted by high yields relative to the perceived risk, better macroeconomic fundamentals, and diversification benefits (IMF 2006, 2007). Countries that have elicited the most investor interest are Botswana, Cameroon, Ghana, Kenya, Malawi, Nigeria and Zambia. Also, Gabon, an oil-exporting middle-income African country, is preparing to raise \$1 billion in international capital markets; it was rated by Fitch in late October 2007 and by Standard and Poor's in November 2007.³⁸

³⁸ Both rating agencies assigned Gabon a BB- rating, citing its relatively high income per capita and large external and fiscal surpluses derived from buoyant oil revenues. The proceeds of the bond will be used to buy back outstanding Paris Club debt. ("Gabon assigned 'BB-' long-term issuer default rating with stable outlook – Fitch" AFX News Limited, October 30, 2007; "International, domestic bonds likely in Gabon-S&P" Reuters, November 9, 2007). Also, Kenya, a B+ rated country, is reported to be planning a Eurobond issuance in the near future.

4. Conclusion

Both official and private flows to Sub-Saharan Africa have increased in recent years, a welcome reversal of the declining or flat trend seen during the 1990s. The picture is less rosy, however, when Sub-Saharan Africa is compared to the other developing regions, and more importantly, to its enormous resource needs for growth, poverty reduction, and other Millennium Development Goals (MDGs). Sub-Saharan Africa outside South Africa continues to depend on official aid. The recent increase in ODA appears to be driven by one-off debt relief provided through HIPC and MDRI; the prospect for scaling up aid is not entirely certain.³⁹ FDI flows to the region are concentrated in enclave investments in oil-exporting countries. Portfolio bond and equity flows are negligible outside South Africa, although several African countries are considering bond issues in international markets. Private debt flows are small and dominated by relationship-based commercial bank lending; and even these flows are largely short-term in tenor. More than half of the countries in the region do not have a sovereign rating from the major credit rating agencies, and the few rated countries have sub-investment grade ratings. Low or absent credit ratings impede not only sovereign, but also private sector efforts to raise financing in the capital markets. Capital outflows appear to be smaller than in the previous decade, but the stock of flight capital from the region remains very high. Migrant remittances appear to be increasing, but a large part of the flows bypass formal financial channels.

In short, the development community has little choice but to continue to explore new sources of financing, innovative private-to-private sector solutions, and public-private partnerships to mobilize additional international financing. An analysis of country creditworthiness suggests that many countries in the region may be more creditworthy than previously believed. Establishing sovereign rating benchmarks and credit enhancement through guarantee instruments provided by multilateral aid agencies would facilitate market access. Creative financial structuring such as the International Financing Facility for Immunization (IFFIm) can help front-load aid commitments, although these may not result in additional financing in the long run. Preliminary estimates suggest that Sub-Saharan African countries can potentially raise \$1-3 billion by reducing the cost of international migrant remittances, \$5-10 billion by issuing diaspora bonds, and \$17 billion by securitizing future remittances and other future receivables.

In raising financing via these means, African countries will face several challenges. Leveraging remittances for Sub-Saharan Africa's development will imply efforts to significantly improve both migration and remittances data. Remittances are private flows, and governments should not try to direct the use of remittances nor should they think of them as a substitute for official aid. Instead, governments should try to reduce costs, increase flows through banking

³⁹ For the literature on aid effectiveness, see Collier (2006); Easterly, Levine, and Roodman (2003); Easterly (2006); Sundberg and Gelb (2006); Radelet (2006); and Rajan and Subramanian (2005).

channels, and constructively leverage on these flows to improve capital market access of banks and governments in poor countries by improving ratings and securitization structures.⁴⁰

Efforts to attract private capital to Africa are constrained by shallow domestic financial markets, lack of securitization laws, a paucity of investment-grade firms and banks in local-currency terms, and absence of national credit-rating agencies. African countries, however, need to be cautious when resorting to market-based debt. It is essential that the borrowing space created by debt relief is used prudently, and not used to borrow excessively at commercial terms (IBRD 2007). “Free riding” by commercial and bilateral creditors can even lead to another round of excessive accumulation of debt. Countries should also monitor and manage short-term external debt (especially those intermediated by domestic banks) to avoid currency and maturity mismatch between assets and liabilities and potential liquidity crisis (Dadush, Dasgupta and Ratha 2000). Short-term capital flows can reverse rapidly with potentially destabilizing effects on the financial markets.

The findings in this paper suggest that Sub-Saharan African countries need to make external finance more broad-based, attract a broader category of investors such as pension funds and institutional investors; and expand public-private partnerships to raise additional external financing.⁴¹ Donors and international financial institutions can play an important role by providing guarantees, political risk insurance, help in establishing ratings, and providing advice on financial instruments such as securitization of remittances and other future-flow receivables. Accessing private capital markets in a responsible manner will require a sound contractual environment as well as credible monetary, fiscal and exchange rate policies.

⁴⁰ Shifting remittances from informal to formal channels may require eliminating parallel market premiums, improving access to formal finance for poor households, and reducing regulatory barriers to entry of new operators.

⁴¹ Since this study has focused on mobilizing new sources of financing, we have omitted discussion of structural and investment climate factors that impede private investment in Africa. This literature is summarized in Bhattacharya, Montiel and Sharma (1997); Bhinda and others (1999); Gelb, Ramachandran and Turner (2006); Kasekende and Bhundia (2000); and World Bank (2002).

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